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BALANCE SHEETS AND BUDGET SURPLUSES: AN ANALYSIS, 1997-1998 – 2003-2004

Marc-André Pigeon
Economics Division

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INTRODUCTION

Between 1997-1998 and 2003-2004, the federal government generated a cumulative budgetary surplus of $61.4 billion. Media reports and even some government statements have, over the years, suggested that these surpluses were used to "automatically" pay down the debt.(1) This is inaccurate. There is no law or convention that says the government must use its budgetary surpluses to *repay* debt, a point emphasized by the Auditor General in her 2002 review of the federal government's financial statements:

> The surplus for the year does NOT automatically pay down the debt. There is neither any law nor accounting rule that requires this. This year's surplus was applied to several areas, only one of which was the reduction of debt. Part of the surplus was used, for example, to support increases in financial assets such as loans, investments and advances.(2)

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(1) In an article discussing larger-than-expected federal surpluses, *Globe and Mail* journalist Simon Tuck wrote, for example, that "Surpluses ... don't go to waste. The extra money recorded at the end of the year is automatically applied to the massive national debt" (8 August 2005, p. A1). In a column in *The Gazette* [Montréal] on 23 June 2005, freelance writer Peter Hadekel wrote that "[b]y law in Canada, a year end surplus is spent automatically to reduce the national debt – and there's an awful lot of debt." In an article in the *Ottawa Citizen* on 10 November 2004, Eric Beauchesne wrote that "[o]nce the year is over, any remaining surplus automatically goes toward debt reduction, as was the case with all of last year's $9.1 billion." Any search of newspapers will reveal numerous other examples. The government has committed similar errors. In *Budget 2001* (p. 19), for example, the government wrote that: "[i]n good economic times the Government paid down a substantial amount of debt – $35.8 billion in the last four years" (note that $35.8 billion is the cumulative amount of surpluses from 1997-1998 through to 2000-2001). This statement is inaccurate because it implies that $35.8 billion was used to buy back or cancel federal market debt, which did not in fact happen.

(2) "Observations of the Auditor General on the Financial Statements of the Government of Canada for the Year Ended March 31, 2002," in Receiver General for Canada, *Public Accounts 2002*, Vol. I, p. 1.39 (emphasis in the original).

The present publication analyzes *from a balance sheet perspective* how in fact the federal government allocated its budgetary surpluses. This analysis is very different from some other "fiscal dividend" allocation analyses conducted by the Department of Finance and think-tank economists, which tend to look either at the value of announced or prospective spending, tax initiatives and debt reduction,(3) or at the actual evolution of spending, taxation and debt reduction relative to a baseline.(4)

The balance sheet analysis reveals that, from a "big picture" balance sheet perspective, 72% of the cumulative budget surplus over the 1997-1998 to 2003-2004 period ended up increasing the federal government's assets and another 14% went to increases in physical assets (land, buildings, equipment), while 14% reduced federal liabilities (i.e., its gross debt). The upshot of this analysis is that while budgetary surpluses are invariably accounted as reducing the accumulated deficit, they do so in two particular ways: by increasing assets – physical or financial – or by reducing liabilities.

Before looking at this balance sheet analysis in detail, it is important to revisit the historical context in which the government has generated its surpluses and then to review some basic accounting principles.

HISTORICAL BACKDROP

For 30 years after World War II, the federal government ran what could be called a cyclical balanced-budget policy. While deficits occurred with some frequency, especially during economic downturns, they were usually quite small – less than 2% of GDP – and were somewhat offset by small surpluses during periods of strong economic growth.(5) Along the way,

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(3) This is the approach used by the Department of Finance in its *Economic Statement and Budget 2000 Update*. See Annex 1, "Spending, Tax Relief and Debt Reduction Since the 1997 Budget," available at http://www.fin.gc.ca/ec2000/eca1e.htm.

(4) This is the approach used by the Canadian Centre for Policy Alternatives' Jim Stanford in *A Funny Way of Sharing: Revisiting the Liberal Government's "50:50" Promise*, available at http://www.policyalternatives.ca/index.cfm?act=news&do=Article&call=130&pA=BB736455.

(5) The federal government generated a string of budgetary surpluses immediately after the war, between 1946-1947 and 1951-1952. From 1952-1953 through to 1974-1975 (the year the debt-to-GDP ratio hit its post-war low), the federal government generated only three other budgetary surpluses, all under 1% of GDP.

the federal debt-to-GDP ratio fell from more than 105% in 1945-1946 to a post-war low of 18.4% by 1974-1975, due largely to the effects of economic growth.(6)

As the first oil shock took its toll on the Canadian and global economies in the early 1970s, governments responded as they had before by increasing spending and incurring deficits to jolt the economy out of recession. Although growth resumed in the mid to late 1970s, the Canadian economy was hit in 1981-1982 with its worst recession since World War II. The recession was aggravated by high interest rates and persistent inflation that had been triggered by a second oil shock made worse by entrenched inflationary expectations. The federal government, for its part, continued to incur large operating and budgetary deficits.(7) While this situation appeared to concern the government, it was not enough to alter the overall fiscal strategy in place since World War II. The federal government responded to the 1981-1982 recession as it had in the past by increasing spending.

The overall direction of budgetary policy changed in 1984, when the newly elected Conservative government made deficit reduction a priority. For the next four years, the deficit fell both in absolute terms (from $37.2 billion in 1984-1985 to $27.9 billion in 1988-1989) and as a percentage of GDP, due to a combination of government spending restraint and tax increases, stronger economic growth and falling interest rates. By 1989-1990, however, the economy had begun to weaken, inflation was creeping higher, interest rates were rising and the deficit was resuming its upward march. In 1990-1991, the Canadian economy slipped into recession, throwing the government's fiscal forecasts off by large margins. The federal government responded by passing the *Spending Control Act*, which set out explicit *program* spending limits for 1991-1992 through to 1995-1996.(8) At the same time, the government

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(6) In the five years immediately after the war, the accumulated deficit fell from a peak of $13 billion in 1945-1946 to a post-war low of $10.4 billion in 1950-1951 before rising year over year to $28.4 billion in 1974-1975. Prior to 1974-1975, growth in nominal GDP almost always exceeded growth in the accumulated deficit. After 1974-1975, the reverse was true.

(7) The "operating balance" refers to the difference between total tax revenue and total *program* expenditures (i.e., *excluding* interest costs on the debt). The "budgetary balance" refers to the difference between total tax revenue and total expenditures, *including* interest costs on the debt.

(8) The Act did not, nor could it, set limits on interest expenses, which are dictated by the terms of the underlying debt issues. The Act also included provisions that allowed the government to exceed the prescribed program spending limits during emergencies (droughts, earthquakes, fires, wars, and other matters of "serious national concern"). Note also that under the Act, certain types of spending were excluded from the definition of "program spending," including for example spending under the *Employment Insurance Act* and the *Farm Income Protection Act*, and spending related to court settlements. Finally, the Act included provisions that allowed the government to, from an accounting perspective, move spending from one fiscal year to the next, backwards and forwards, so as to satisfy the Act's spending limits.

created a "Debt Servicing and Reduction Fund," which would receive "net revenues from the Goods and Services Tax, net proceeds from privatization, and earmarked contributions for debt reductions from individuals or businesses."[9] While the fund ultimately aimed to reduce market debt, proceeds were used entirely to pay debt interest costs, which easily exceeded annual revenue recorded in the fund. The federal government nevertheless said that with the help of the *Spending Control Act*, it expected to generate cash surpluses,[10] also known as "financial requirements/source" account surpluses, by 1994-1995. At that point it would "begin paying back the debt it had previously borrowed on capital markets."[11]

Circumstances dictated otherwise, however, and the federal deficit continued to grow, largely because of rising interest costs on the debt. In 1993-1994, the newly elected Liberal government promised to reduce the deficit-to-GDP ratio to 3% of GDP by 1996-1997, with its "ultimate" objective being a balanced budget that would be achieved over the course of an economic cycle.[12] As the government noted in its December 1995 *Economic and Fiscal Update*, "[i]n periods of economic boom – when the level of activity is straining the economy's capacity to produce – the budget should be in surplus. In periods of economic slack, when unemployment rises and income growth is weak, the federal budget may be in deficit."[13] To achieve this goal, the new government cut spending, privatized several large Crown corporations and broadened the tax base. The government was successful in its efforts, exceeding its deficit-reduction targets due in part to spending restraint but largely because of lower interest costs on the debt and stronger economic growth.

The federal government registered its first budgetary surplus in almost 30 years in 1997-1998. The ensuing seven years of consecutive surpluses can be broken down into two policy eras. The first era begins in 1997-1998 and extends through to 2000-2001. With the exception of the early spring *Budget 2000* and the fall 2000 *Economic Statement and Budget Update*, this era is characterized by a cautious attitude towards surpluses, with relatively few

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(9) Government of Canada, *Budget 1991*, p. 55.

(10) As explained below, cash surpluses are *not* equal to budget surpluses; see the section entitled "Some Basic Accounting Principles."

(11) Government of Canada, *Budget 1990*, p. 93.

(12) Government of Canada, *Economic and Fiscal Update*, December 1995, p. 40. Note that while the Liberal government adhered to the terms of the *Spending Control Act* through to 1995-1996, the Act was not extended to cover future years.

(13) *Ibid*., p. 38.

major new expenditures or tax cuts. The first period began with a promise in the October 1997 *Economic Statement and Budget Update* that the federal government would adhere to a "50:50 rule," with 50% of any surpluses allocated to spending and the other 50% to tax cuts and debt reduction.(14) In *Budget 1998*, the government also introduced what it called the Debt Repayment Plan, which consisted of a pledge to use its contingency reserve, which consists of anticipated revenue set aside for unexpected expenses and emergencies, to "pay down the public debt" in the event that the reserve was not needed for the former purposes. In this way, the Debt Repayment Plan took care of the debt reduction aspect of the 50:50 plan. The 50:50 objective was to be achieved over the course of the government's mandate. The 2000 *Economic Statement and Budget Update*, issued just prior to the fall 2000 election, included a study that suggested the government largely achieved its 50:50 objective during its second mandate, devoting 38.4% of its surpluses to spending and 61.6% to tax cuts and debt reduction.(15)

The second era begins at the start of the third Liberal government mandate, from December 2000 through to the present. During this period, the federal government has no longer discussed the 50:50 formula publicly, presumably because it ceased to be a guiding principle for planning purposes.(16)

SOME BASIC ACCOUNTING PRINCIPLES

As indicated in the introduction, the balance sheet analysis discussed below differs markedly from the Department of Finance exercise from the 2000 *Economic and Fiscal Update* or from work done by non-governmental economists. Some understanding of balance sheets is necessary in order to properly understand the analysis presented here.

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(14) Government of Canada, *Economic and Fiscal Update 1997*, p. 39, available at: http://www.fin.gc.ca/update97/factOVER-E.html.

(15) The study notes that if "targeted tax measures" are included in the spending category, then 46.5% of the surpluses were used for spending and 53.5% for tax cuts and debt reduction. As indicated in the introduction, both calculations have been challenged by at least one non-governmental economist.

(16) In October 2005, the government announced a new surplus allocation policy along with legislation to put that policy into effort. Under the proposed legislation, the federal government would divide up any surplus amount exceeding the $3 billion set aside for the contingency reserve in three equal parts, intended for: (i) debt reduction; (ii) increased program spending; and (iii) a one-time tax credit.

The first thing that must be understood is that balance sheets present a financial picture or snapshot of a moment in time. The federal government's balance sheet, which is normally published each fall in a series of audited statements called the *Public Accounts of Canada*,[17] provides a detailed financial picture of the federal government's financial situation as of 31 March, the government's fiscal year-end. The *Public Accounts* also contain cash-flow statements, which provide a picture of the sources and uses of the federal government's cash resources.

The *Public Accounts* statements do not, however, indicate precisely which tax revenue stream financed which spending project, because federal tax revenues flow into what is called the Consolidated Revenue Fund. Money in this account is used as needed, without any specific link between the type of tax and the resulting expenditure.[18] Short of somehow marking money or creating segregated accounts for each tax revenue stream, it is impossible to trace which money finances which spending.[19] The situation is analogous to an individual's main chequing account at a bank. Each pay-cheque increases the account balance and each withdrawal reduces the account balance. There is no way to be sure that *this* grocery store purchase came out of *that* pay-cheque or, more generally, to attribute *this* expenditure to *that* particular income flow.[20]

In that sense, and only in that sense, it is impossible to say *how* the federal budgetary surpluses have been used. The most that can be said is that the federal government generated such-and-such a surplus and that it paid down its debt by such-and-such an amount, without implying any necessary link between a pot of money called "the surplus" and a reduction of an accumulated stockpile of debt.

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(17) These documents are audited by the Office of the Auditor General of Canada.

(18) In fact, the federal government has long resisted tying specific tax revenue sources to specific expenditures, as can be seen with employment insurance (EI) premiums. For a number of years now, labour groups and employers have complained that the federal government has collected far more in EI premiums than it has paid out in benefits, to the point where there is a notional – or purely accounting – surplus of some $47.8 billion (2004-2005 forecast).

(19) This kind of tracking process is much easier in the world of physical things as opposed to intangibles such as money. For example, several provinces "dye" or "mark" gasoline to help distinguish between fuel used by farmers, which is excise tax-free, and fuel used by the general population.

(20) This statement is true in all circumstances except in the case where someone has made only one deposit into an account.

The claim that budgetary surpluses automatically pay down the debt is based in part on the failure to understand this subtlety, and also on a misunderstanding that is based on a truth, namely that the accumulated deficit, which is sometimes misleadingly also called the "federal debt," has indeed fallen by an amount that is the same as that of the cumulative surplus (i.e., $61.4 billion since 1997-1998). The misunderstanding or inaccuracy lies in the fact that the accumulated deficit is *not* analogous to a home mortgage or car loan and *cannot* be "paid down." The only thing that is analogous to a home mortgage or car loan in the federal government's books is something called "market debt," which consists of marketable bonds, treasury bills, and non-market debt (Canada Savings Bonds). Since 1997-1998, market and non-market debt has fallen by $38.6 billion, representing about 63% of the cumulative budgetary surplus.

The accumulated deficit is better understood as a pure accounting concept, similar to the "net worth" calculations a person might make when applying for a home mortgage or, for those familiar with business accounting, the concept of shareholders' equity. Like these two accounting concepts, the accumulated deficit is simply the difference between total assets and total liabilities. The federal government's liabilities, however, outweigh its assets by a considerable margin – some $501.5 billion at the end of 2003-2004. In light of that fact, it evidently makes no more sense to say the government "paid down" its accumulated deficit by the amount of the surplus than it does to say that adding $1,000 to a bank account is the same thing as paying down your mortgage by $1,000: your net worth or capacity to repay debt improves, but debt owed is still the same until you put that money towards your mortgage.

This may seem like hair splitting, but consider: $1,000 in a bank account can just as easily be used to buy a new television or computer as to pay off a credit card bill or the principle on a mortgage. Money in the bank is still available for discretionary uses (i.e., is fungible); money used to pay down a loan or mortgage is not. As this publication will show, a balance sheet analysis reveals that a significant portion of the budgetary surpluses ended up in increased government cash reserves rather than being used to pay down market and other tangible debt.

Before looking at the balance sheet allocation of the budgetary surpluses in detail, it is also important to note that "budgetary surpluses" are not identical to "cash-flow surpluses." A budgetary surplus of $9.1 billion (the surplus for 2003-2004) does *not* mean that the

government collected $9.1 billion more in taxes than it paid out in wages, on social programs and debt costs. The concept of a "budgetary surplus" is itself something of an accounting artifact, resulting from the government's use of full-accrual accounting. Amongst other things, this method of accounting attributes tax revenue and spending to the period to which the money in question relates, not to the period when the actual revenue is received or the spending disbursed. To illustrate, consider a tax payment (a cash inflow) received by the federal government in the 2005-2006 fiscal year but due for taxes owing in 2001-2002. This revenue would, for accounting purposes and the purposes of calculating the budgetary surplus, be attributed to 2001-2002 and not 2005-2006.

The "financial requirements/source" entry in the government's fiscal reference tables is the only place to find out the actual difference, in any given year, between cash coming in from tax revenue and cash going out for expenditures. This "cash-in, cash-out" account is therefore a better measure of the government's ability to repay market debt for any given fiscal year. During the era of large deficits and growing debt in the late 1980s and into the 1990s, for example, the federal government often said it would begin "reducing its outstanding debt in the form of Treasury bills, Canada Savings Bonds and other debt instruments held by the general public" as soon as its "financial requirements/source" turned positive *even though* it anticipated it would take several more years to produce a budgetary surplus.(21)

In summary, media reports and government documents would be clearer and more accurate if they stated that the accumulated deficit was *reduced* by the amount of the surplus, and if they reported separately on the amount of market and non-market debt that had been repaid. Moreover, to understand the government's cash-flow picture in any given fiscal year, it is best to look at the "financial requirements/source" concept.

(21) *Budget 1990*, p. 110, stated that the federal government expected to begin repaying market debt by 1994-1995 even though the budgetary deficit was still expected to be about $10 billion.

A BALANCE SHEET ANALYSIS OF THE SURPLUSES

The change in the federal government's balance sheet from 1997-1998 to 2003-2004 can be looked at from two vantage points, one more detailed than the other.

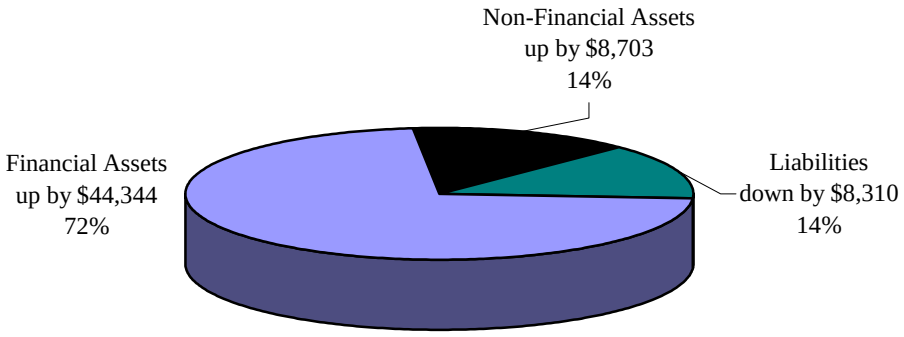
Table 1: A "Big Picture" View of Changes in the Government's Balance Sheet, 1997-1998 to 2003-2004 ($ million)

Total Liabilities reduced by	$8,310
Total Financial Assets increased by	$44,344
Total Non-Financial Assets increased by	$8,703
Accumulated Deficit reduced by	$61,357

The "big picture" view in Table 1 looks at the change in the balance sheet's three main components during 1997-1998 to 2003-2004, namely total liabilities, total financial assets and total non-financial assets. In so doing, it also illustrates the relationship between the net debt and the accumulated deficit: the former is the difference between total liabilities and total financial assets, while the latter is the difference between total liabilities and total financial assets plus total non-financial assets.[22]

(22) Prior to the government's switch to full-accrual accounting in 2002-2003, net debt and accumulated deficit meant the same thing because the government did not account for the value of its non-financial (i.e., physical) assets. Indeed, the major conceptual change resulting from full-accrual accounting is best characterized as a timing issue. Instead of, for example, recording expenditures when cash is spent, which was the case under the old modified accrual system, the government now records expenses as resources are consumed. As a result, the government now records the financial value of its physical assets (equipment, vehicles, and buildings) instead of "expensing" them when purchased. Assets are then amortized as their value declines (i.e., as the resources are consumed). Something similar is done on the liability side: the government now tries to estimate all its future liabilities, including, for example, pension liability, environmental liabilities, and liabilities related to future land-claim settlements. Similarly, tax revenues are attributed to the period to which they relate, not the period when they are received. These changes, and others, are designed to provide more complete and accurate information on the government's activities.

Figure 1: A Balance Sheet Perspective on the Allocation of the $61.4 Billion in Cumulative Budget Surpluses ($ million)



Source: Data obtained from the *Public Accounts of Canada 2003-2004*; figure prepared by Marc-André Pigeon, Parliamentary Information and Research Service, Library of Parliament.

Figure 1, which illustrates data from Table 1, shows that 72% of the cumulative budget surplus over the 1997-1998 to 2003-2004 period ended up as increases in the federal government's financial assets, another 14% went to increases in physical assets (land, buildings, equipment), while 14% was put towards reducing its liabilities (i.e., its gross debt). In absolute numbers, the government's total liabilities – the sum total of what it owes – fell by $8.3 billion, while its financial assets increased by $44.3 billion and its non-cash assets increased by $8.7 billion.

While this "big picture" perspective is instructive, it does not tell the whole story. Table 2 and Figures 2 and 3 present the same data, but this time in greater detail. Table 2 reproduces the main features of the federal balance sheet found in the *Public Accounts*[(23)] but instead of depicting annual data, it shows the net change in each balance sheet category during the 1997-1998 to 2003-2004 period. To illustrate the relationship between Table 1 and Table 2, changes in the three major balance sheet categories – total liabilities, total financial assets and total non-financial assets – are printed in bold red letters in shaded cells. The cumulative change, which as noted earlier is identical to the cumulative surpluses generated during the period in question, is printed in bold black letters at the bottom of Table 2.

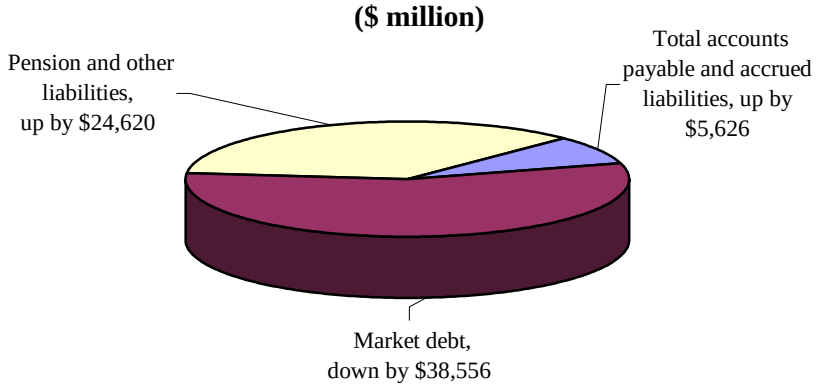
(23) For ease of presentation, some of the stylistic features of the original table have been altered and some categories moved around. Otherwise, the table is identical to what is typically found in the *Public Accounts.*

Table 2: The Federal Government's Balance Sheet, Changes in Key Variables, 1997-1998 to 2003-2004 ($ million)

BALANCE SHEET	CHANGE
LIABILITIES	
Accounts Payable and Accrued Liabilities	
Accounts payable and accrued liabilities	$7,224
Tax payables	$7,964
Interest and matured debt	-$7,079
Allowance for guarantees	-$2,483
Total accounts payable and accrued liabilities	**$5,626**
Interest-Bearing Debt	
Unmatured debt	-$38,556
Pension and other liabilities	$24,620
Public sector pensions	$13,355
Other employee and veteran future benefits	$5,971
Due to Canada Pension Plan	$3,765
Other liabilities	$1,529
Total interest-bearing debt	**-$13,936**
TOTAL LIABILITIES	**-$8,310**
FINANCIAL ASSETS	
Cash and Accounts Receivable	
Cash	$10,371
Tax receivables	$8,570
Other accounts receivable	-$791
Total cash and accounts receivable	**$18,150**
Foreign Exchange Accounts	
International reserves held in the Exchange Fund Account	$14,521
International Monetary Fund – Subscriptions	$3,890
Less: International Monetary Fund – Notes payable and SDR Allocations	-$911
Total net foreign exchange accounts	**$17,500**
Loans, Investments and Advances	
Enterprise Crown corporations and other government business enterprises	$1,020
National governments including developing countries and international organizations	$919
Other loans, investments and advances	$10,770
Less: allowance for valuation	-$4,015
Total loans, investments and advances	**$8,694**
TOTAL FINANCIAL ASSETS	**$44,344**
Net Debt	-$52,654
Non-Financial Assets	
Tangible capital assets	$8,492
Inventories	$162
Prepaid expenses	$49
TOTAL NON-FINANCIAL ASSETS	**$8,703**
ACCUMULATED DEFICIT	**-$61,357**

Source: Data obtained from the *Public Accounts of Canada 2003-2004*; table prepared by Marc-André Pigeon, Parliamentary Information and Research Service, Library of Parliament.

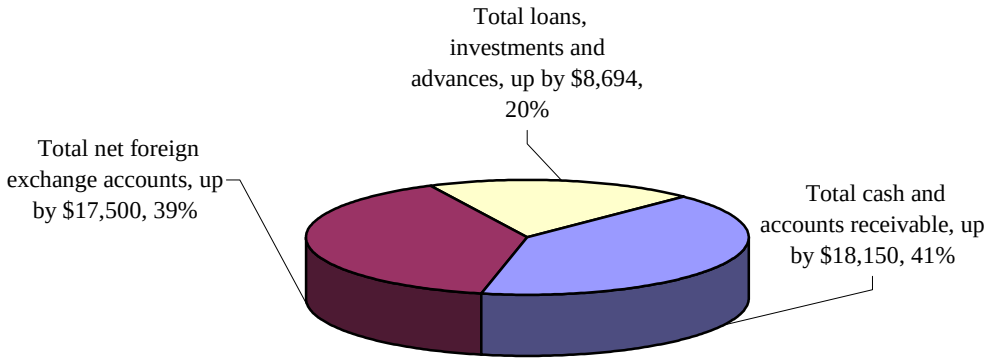
Figure 2: A Breakdown of the Change in Total Liabilities, 1997-1998 to 2003-2004 ($ million)



Source: Data obtained from the *Public Accounts of Canada 2003-2004*; figure prepared by Marc-André Pigeon, Parliamentary Information and Research Service, Library of Parliament.

Figure 2 breaks down the change in total liabilities shown in Figure 1 into three major categories. It shows the government actually paid down (in the fullest sense of the term) a large amount of debt: what is often called "market debt" fell by $38.6 billion. This reduction, however, was offset by *increased* liabilities for the federal government's employee pension plans, veterans' pension plans, and money owed to the Canada Pension Plan, presumably for its employees. These items cannot be "paid down" in the same way as market debt because they involve contractual liabilities. The overall effect of these opposing changes was that the government's total liabilities fell by only $8.3 billion.

Figure 3: A Breakdown of the Change in the Total Assets, 1997-1998 to 2003-2004 ($ million)



Source: Data obtained from the *Public Accounts of Canada 2003-2004*; figure prepared by Marc-André Pigeon, Parliamentary Information and Research Service, Library of Parliament.

On the assets side, Figure 3 shows that the 72% increase in financial assets depicted in Figure 1 was due to a 41% increase in cash and tax (accounts) receivable, a 39% increase in the government's foreign exchange accounts, and a 20% increase in its loans and investments. The large increase in cash and tax receivable suggests that the government has set aside a considerable, and very liquid, cushion to handle unexpected expenditures. Although both the foreign exchange account and the government's loans and investments also increased in value, these funds are not nearly as available for other purposes.

CONCLUSION

There is no way to identify how budget surpluses are specifically used, because tax revenue and expenditures flow into and out of the Consolidated Revenue Fund. While some news reports and government statements assert or imply that the surplus is used to "pay down the debt," the reality is more complex. Annual surpluses have reduced the government's net indebtedness, but this does not mean that the improvement was achieved simply by reducing market debt. An analysis from a balance sheet perspective of how the surpluses were allocated shows that while the government did make substantial reductions in its market debt, these reductions were not equal to the cumulative surpluses generated over the 1997-1998 to 2003-2004 period. Moreover, these reductions were largely offset by a rise in pension liabilities. The analysis also reveals that the government's cash or liquid assets have increased markedly over the period in question, suggesting that the federal government has left itself considerable financial room to handle unexpected expenses.

APPENDIX

ACCOUNTING BACKGROUND AND A WORD ON DEBT MANAGEMENT

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ACCOUNTING BACKGROUND

The government's financial statements are presented according to accounting standards set out by the Canadian Institute of Chartered Accountants. Those standards require the statements to include five key indicators or "messages," one of which is the accumulated surplus (or deficit).(1) The accumulated surplus/deficit "represents the sum of all of the annual surpluses and deficits ever reported by that government."(2) Thus, each annual surplus or deficit reported by the government changes the amount of the accumulated deficit.

To get a better sense of the reasoning behind what is ultimately a simple accounting concept, it is first important to note that from an accounting perspective, surpluses are a "flow" – think of water flowing into a bathtub – while the accumulated deficit is a "stock" – think of the water level *in* the bathtub. The accumulated deficit is a snapshot of the amount of deficit at a particular moment in time, namely the government's fiscal year-end of 31 March. The accumulated deficit is adjusted each year to reflect the amounts that have been added (new debts incurred) or removed (liabilities reduced), much as shareholders' equity on corporate balance sheets, or an individual's net worth, *varies necessarily* by the amount of profits, losses and net income.

Market debt is the *only* government liability that can be repaid in any meaningful sense. Government pension liabilities, for example, are determined by the government's workforce and cannot be easily reduced. Even a portion of the government's market debt cannot easily be repaid: with the exception of callable debt (which gives the government the right to buy back its debt whenever it sees fit), the best the government can do is *offer* to purchase its debt from market participants. This has important implications for how the government manages its debt.

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(1) Public Sector Accounting Board of the Canadian Institute of Chartered Accountants, *20 Questions About Government Financial Reporting: Federal, Provincial and Territorial Governments*, Ottawa, 2003, p. 10.

(2) *Ibid*., p. 27.

A WORD ON DEBT MANAGEMENT

The suggestion that surpluses are used automatically to pay down the accumulated deficit could easily give rise to the impression that at the end of every fiscal year, the government purchases market debt equal to the surplus in one single operation.

This is an oversimplification. In fact, prudent debt management would require the Department of Finance to repurchase market debt when conditions are most favourable. The Department of Finance must also be wary of altering the maturity structure of the government's debt: too much short-term debt could expose the government to sharp increases in interest rates (a situation that prevailed in the late 1980s and early 1990s), while too much long-term debt could saddle the government with unnecessarily high interest costs.

It is also important to keep in mind that government debt is an important asset for the financial sector, serving first as a "safe haven" in times of economic and political uncertainty and second as a benchmark for other government (provincial and municipal) and non-government (corporate) debt.(3) In fact, a preferred way to reimburse the debt may simply be to pay debt as it matures. This approach means that the government is not forced to pay high debt costs (in an era of low interest rates such as now exists) and assures a certain stability to the term structure of all federal debt.(4)

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(3) Federal, domestically denominated debt is considered relatively risk-free: the government can always, if pressed, print the money necessary to pay back the nominal value of its debt.

(4) By assuring some stability in the range of debt maturities, the government helps maintain a diversified investor base, which in turn helps reduce debt costs: the broader the base of persons willing to buy government debt, the better the terms that can be obtained by the government (i.e., lower interest rate costs).